

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-06 ISO-00 TRSE-00 FRB-03 AID-05 CIAE-00

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R 191339Z JUN 75

FM AMEMBASSY LONDON

TO SECSTATE WASHDC 2134

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION OECD PARIS

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DEPARTMENT PASS TREASURY FOR SYVRUD AND FRB

E.O. 11652: N/A

TAGS: EFIN, UK

SUBJECT: FORECAST OF 1975 UK CURRENT ACCOUNT DEFICIT

BEGIN SUMMARY: MOST FORECASTS OF 1975 UK CURRENT ACCOUNT DEFICIT ESTIMATE AN IMPROVEMENT OF ABOUT 1 BILLION POUNDS OVER THE 1974 DEFICIT. HOWEVER, WITH FIVE MONTHS DATA NOW AVAILABLE, IT APPEARS THAT THE IMPROVEMENT IS LIKELY TO BE AS MUCH AS 2 BILLION POUNDS. EXPORT PERFORMANCE HAS BEEN MUCH BETTER THAN EXPECTED AND THE VOLUME OF IMPORTS HAS FALLEN SHARPLY. IN VALUE TERMS, EXPORTS ARE EXPECTED TO RISE YEAR-ON-YEAR IN THE RANGE OF 20-25 PERCENT WHILE THE VALUE OF IMPORTS IS EXPECTED TO SHOW ONLY A MODERATE INCREASE. MUCH OF THE CURRENT ACCOUNT IMPROVEMENT RESULTS FROM THE DEEPENING OF RECESSION IN THE UK AND THE RESULTANT REDUCTION IN CONSUMER DEMAND COMBINED

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WITH THE POSITIVE CURRENT ACCOUNT EFFECTS OF CONTINUED

STERLING DEPRECIATION. IT NOW APPEARS THAT THE UK WILL HAVE LITTLE DIFFICULTY IN FINANCING THE CURRENT ACCOUNT DEFICIT THIS YEAR ALTHOUGH PROBLEMS COULD ARISE IN FINANCING CAPITAL OUTFLOWS IF A SPECULATIVE RUN ON STERLING DEVELOPS AND THE RATE IS DEFENDED. END SUMMARY

1. IN RECENT MONTHS THERE HAS BEEN A CONSISTENCY IN THE VARIOUS FORECASTS RELATING THE UNITED KINGDOM'S CURRENT ACCOUNT POSITION DURING 1975. OFFICIAL (H.M. TREASURY), PRIVATE UK (NIESR AND LONDON BUSINESS SCHOOL), AND THE OECD HAVE ALL FORECAST AN EXPECTED IMPROVEMENT IN THE DEFICIT OF ABOUT 1 BILLION POUNDS DURING 1975. CHANCELLOR HEALEY REINFORCED THIS PROJECTION IN HIS APRIL 15 BUDGET STATEMENT WHEN HE ANNOUNCED TO PARLIAMENT AN EXPECTED IMPROVEMENT OF "AT LEAST" 1 BILLION POUNDS IN THE UK'S CURRENT ACCOUNT DEFICIT, 1975 OVER 1974. WITH THE AVAILABILITY OF FIVE MONTH'S DATA, IT APPEARS THAT THE IMPROVEMENT WILL BE MUCH GREATER THAN 1 BILLION POUNDS AND MAY REACH AS HIGH AS 2 BILLION POUNDS, YEAR-ON-YEAR.

2. EVEN IF THE CURRENT LEVEL OF IMPROVEMENT IS CONSIDERED UNSUSTAINABLE, IT IS SOMEWHAT SURPRISING THAT MANY OF THE FORECASTERS' CURRENT PROJECTIONS (AND IN PARTICULAR THE OECD'S) DO NOT APPEAR TO TAKE INTO ACCOUNT THE ACTUAL PERFORMANCE DURING THESE FIRST FIVE MONTHS (SEE NOTE 1 BELOW). COMBINING THE ACTUAL PERFORMANCE TO DATE WITH THE IMPORT DEMAND EFFECT OF STERLING DEVALUATION, THE REDUCED INCOME EFFECT OF THE APRIL BUDGET AND EXPECTED CONTINUED IMPROVEMENT IN THE TERMS OF TRADE, WE FEEL, ADDS UP TO MORE SUBSTANTIAL IMPROVEMENT IN THE 1975 CURRENT ACCOUNT DEFICIT THAN MANY OF THE FORECASTS INDICATE.

3. WHILE WE DO NOT PURPORT TO BELIEVE THAT THE IMPROVEMENT WILL RESULT FROM A MAJOR STRUCTURAL SHIFT IN THE EXTERNAL SECTOR OF THE UK ECONOMY, THE PERFORMANCE DURING THE FIRST MONTHS OF THE YEAR MUST BE TAKEN INTO ACCOUNT WHEN ASSESSING THE EXPECTED YEAR-END POSITION. DURING THE FIRST FIVE MONTHS OF 1975, UK EXPORTS AVERAGED 1,504 MILLION POUNDS PER MONTH WHILE IMPORTS AVERAGED 1,708 MILLION POUNDS PER MONTHS, YIELDING AN AVERAGE MONTHLY TRADE DEFICIT OF 205 LIMITED OFFICIAL USE

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MILLION POUNDS. RECOGNIZING THAT FACTORS SUCH AS THE PORT OF LONDON DOCK STRIKE DURING FEBRUARY AND MARCH DISTORTED THE MONTH-TO-MONTH DATA, THE FIRST FIVE MONTHS TAKEN AS A WHOLE SHOULD SMOOTH OUT THE STATISTICAL ANOMALIES. NONETHELESS, IN ORDER TO ACHIEVE A CURRENT ACCOUNT IMPROVEMENT OF ONLY 1 BILLION POUNDS, THE TRADE DEFICIT WOULD HAVE TO AVERAGE IN EXCESS OF 450 MILLION POUNDS PER MONTH FOR THE

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FM AMEMBASSY LONDON

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REMAINING 7 MONTHS, OR A MONTHLY AVERAGE GREATER THAN THE 1974 MONTHLY AVERAGE. (THIS ASSUMES THAT THE SURPLUS ON INVISIBLES CONTINUE TO AVERAGE ABOUT 120 MILLION POUNDS PER MONTH, WHICH IF ANYTHING, IS AN UNDERSTATEMENT.)

4. AN EXAMINATION OF THE FIRST FIVE MONTHS' TRADE DATA PLUS EXTENSIVE TALKS WITH BANK OF ENGLAND, H.M. TREASURY AND OECD SECRETARIAT STAFF LEADS US TO THE FOLLOWING OBSERVATIONS:

A: THE VOLUME OF UK EXPORTS WILL REMAIN FAIRLY FLAT DURING 1975 SHOWING ONLY MARGINAL GROWTH. THIS WILL RESULT IN PART FROM A RUNDOWN OF EXPORT ORDER BACKLOGS, BUT IN ADDITION, THERE IS GROWING ANTICIPATION IN OFFICIAL CIRCLES THAT EXPORT SALES TO MIDDLE EASTERN AND DEVELOPING COUNTRIES WILL BE SUBSTANTIAL-

LY GREATER IN 1975 COMPARED TO 1974. THE AVERAGE  
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EXPORT VOLUME DURING THE FIRST FIVE MONTHS WAS 0.7 PERCENT GREATER THAN THE 1974 AVERAGE. THERE IS, OF COURSE, A GROWING CONCERN THAT THE CURRENT LEVEL OF INFLATION WILL ERODE EXPORT COMPETITIVENESS BUT THE DEVALUATION OF STERLING (THAT ALREADY WITNESSED AND THE EXPECTATION OF A CONTINUED WEAKENING POSITION) SHOULD OFFSET, TO A SUBSTANTIAL DEGREE, THIS EROSION.

B: IN VALUE TERMS, WE EXPECT THE UK EXPORTS TO INCREASE AROUND 20-25 PERCENT, 1975 OVER 1974. CURRENT H.M. TREASURY ESTIMATES INDICATE EXPORT SALES OF APPROXIMATELY 18.5 BILLION POUNDS IN 1975 COMPARED TO 15.6 BILLION POUNDS IN 1974; THE NIESR FORECAST IS SLIGHTLY HIGHER. THIS WILL RESULT ALMOST EXCLUSIVELY FROM HIGHER PRICES AS A RESULT OF THE EXCESSIVELY HIGH RATE OF UK DOMESTIC INFLATION. THERE HAS BEEN AN INCREASE IN THE VALUE OF EXPORTS OF 15 PERCENT (36 PERCENT AT AN ANNUAL RATE) DURING THE FIRST FIVE MONTHS COMPARED WITH THE 1974 AVERAGE VALUE.

C: IMPORT VOLUME, WHICH HAS DECREASED BY 9 PERCENT IN THE FIRST FIVE MONTHS COMPARED TO THE 1974 AVERAGE LEVEL SHOULD CONTINUE TO SHOW DECLINE YEAR-ON-YEAR. THE MAJOR FACTOR IN THE REDUCED LEVEL OF IMPORTS IS THE RECESSIONARY INFLUENCE WHICH IS CURRENTLY IMPACTING ON THE ECONOMY. IN ADDITION, THERE HAS BEEN A RUNDOWN OF INVENTORIES FOR THE PAST SEVERAL MONTHS WHICH CONTRIBUTED SIGNIFICANTLY TO THE REDUCTION IN IMPORTS. HOWEVER, WE DO NOT EXPECT A RENEWED BUILDUP OF STOCKS UNTIL THE RECESSION SHOWS SIGNS OF ABATEMENT. WITH DOMESTIC INFLATION EXPECTED TO CONTINUE IN DOUBLE DIGITS THROUGHOUT THE YEAR AND UNEMPLOYMENT RISING, THE IMPACT ON THE VOLUME OF IMPORTS SHOULD BE A CONTINUATION OF THE REDUCTION EXPERIENCED IN RECENT MONTHS. IN ADDITION, THE EXPECTED REDUCTION IN IMPORT VOLUME WILL BE ENHANCED BY REDUCED IMPORT DEMAND RESULTANT FROM THE PRICE EFFECT OF STERLING DEVALUATION; REDUCED CONSUMER EXPENDITURE; THE INCREASE IN VALUE ADDED TAX TO 25 PERCENT ON "LUXURY ITEMS, (ALTHOUGH ADMITTEDLY A MARGINAL ELEMENT) A SUBSTANTIAL PORTION OF WHICH ARE IMPORTED GOODS; STABLE LEVEL OF PETROLEUM IMPORTS ALTHOUGH SOME BUILDUP IS EXPECTED TOWARDS YEAR-END IN ANTICIPATION OF THE

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WINTER MONTHS. THERE WAS A RUNDOWN OF OIL STOCK DURING THE RELATIVELY MILD WINTER WHICH IN PART ACCOUNTS FOR THE REDUCED IMPORT BILL. HOWEVER, THERE WOULD HAVE TO BE A MAJOR RESURGENCE OF DEMAND TO PUSH THE OIL IMPORT LEVEL BACK TO THAT OF 1974, ALTHOUGH THIS IS CONSIDERED UNLIKELY GIVEN THE REDUCED LEVEL OF DEMAND FOR INDUSTRIAL USE.

D: IMPORTS WILL INCREASE IN VALUE TERMS DESPITE THE FALL IN WORLD COMMODITY PRICES, DUE TO A LARGE EXTENT TO THE DEPRECIATION OF STERLING. THIS WILL BE PARTIALLY OFFSET BY THE EXPECTED REDUCTION IN IMPORT VOLUME.

E: WHILE THE VALUE OF BOTH IMPORTS AND EXPORTS WILL INCREASE IN ABSOLUTE TERMS, THE RISE IN THE VALUE OF IMPORTS IS NOT EXPECTED TO BE AS GREAT AS THE INCREASE IN VALUE OF EXPORTS. THEREFORE, IT IS EXPECTED THAT THE TERMS OF TRADE WILL CONTINUE TO SHOW IMPROVEMENT THROUGHOUT THE YEAR.

F: THE BALANCE ON INVISIBLE TRADE WILL REMAIN ROUGHLY AT THE 1974 LEVEL, OR ON AVERAGE, SHOW A SURPLUS OF AT LEAST 120-125 MILLION POUNDS PER MONTH. THIS MAY, HOWEVER, BE AN UNDERSTATEMENT OF THE INVISIBLES SURPLUS. THE NIESR FORECAST AN AVERAGE MONTHLY SURPLUS OF ABOUT 133 MILLION POUNDS DURING THE SECOND HALF OF 1975. WHILE IT IS RECOGNIZED THAT THE DEVALUATION OF STERLING HAS AN EFFECT ON THE INVISIBLES BALANCE, WE EXPECT THAT THE RESULTANT INCREASE IN THE STERLING COST OF INTEREST PAYMENTS ON UK OVERSEAS BORROWING

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WILL BE OFFSET BY THE INCREASE IN REMITTED PROFITS  
ON UK OVERSEAS INVESTMENT.

G: STERLING HAS SHOWN A SUBSTANTIAL DEPRECIATION SINCE  
THE BEGINNING OF THE YEAR, IN PARTICULAR AGAINST CON-  
TINENTAL CURRENCIES. ON THE BANK OF ENGLAND'S TRADE-  
WEIGHTED BASIS, THE AVERAGE DEPRECIATION OF STERLING  
HAS WIDENED BY NEARLY 15 PERCENT SINCE THE END OF  
DECEMBER. AS MEASURED AGAINST SMITHSONIAN PARITIES,  
THE AVERAGE DEPRECIATION WIDENED FROM THE DECEMBER  
30, 1974 LEVEL OF 21.6 PERCENT TO 24.7 PERCENT ON  
MAY 30. (THE EARLY DAYS OF JUNE SAW THE AVERAGE  
WIDENED TO AS MUCH AS 26.5 PERCENT OR A DECLINE OF  
SOME 22.5 PERCENT SINCE DECEMBER.) WHILE WE EXPECT  
THIS UNDERLYING TREND IN STERLING TO CONTINUE, WE DO  
NOT EXPECT TO SEE AS GREAT A FALL OVER THE REMAINDER  
OF THE YEAR, POSSIBLY 1.5 TO 2.5 PERCENT PER QUARTER.

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TWO TRENDS ARE EXPECTED; STERLING WILL SHOW SOME  
STRENGTH VIS-A-VIS THE CONTINENTAL CURRENCIES AS UK  
INTEREST RATES RISE AND INCREASE THE RELATIVE DIFFER-  
ENTIAL. THE MAJOR WEAKNESS TO DATE HAS BEEN AGAINST  
THESE CURRENCIES. ON THE OTHER HAND, WITH EXPECTED  
STRENGTHENING OF THE DOLLAR, THE STERLING/DOLLAR RATE  
SHOULD FALL SOMEWHAT, ERODING THE RELATIVE STABILITY  
BETWEEN THESE TWO CURRENCIES. THERE IS GROWING CON-  
SENSUS AMONG MAJOR FOREIGN EXCHANGE DEALERS (AND  
THEREFORE POSSIBLY SELF-FULFILLING EXPECTATIONS)  
THAT STERLING WILL CONTINUE TO WEAKEN BUT TO A GREAT-  
ER DEGREE AGAINST THE DOLLAR. IF THIS PATTERN OF  
DEPRECIATION DOES DEVELOP, THE WEAKER POSITION VIS-  
A-VIS THE DOLLAR WOULD GIVE A BOOST TO BRITAIN'S  
TRADE WITH NON-EEC COUNTRIES AND IN PARTICULAR WITH  
OIL-PRODUCING COUNTRIES WITH DOLLAR SURPLUSES.

5. WHILE THERE IS A LONG LAG IN THE RELEASE OF DISAGGRE-  
GATED DATA AND WE LACK THE FACILITIES FOR DETAILED ANAL-

YSIS EVEN WHEN AVAILABLE, WE OFFER THE FOLLOWING IDEAS AS PARTIAL EXPLANATIONS OF THE FIRST FIVE MONTHS' PERFORMANCE. IN TURN THESE MAY AID IN ASSESSING THE EXPECTED PERFORMANCE OVER THE REMAINDER OF THE YEAR.

A: SEVERAL ESTIMATES OF THE INCOME ELASTICITY OF BRITISH EXPORTS YIELD RESULTS AT LESS THAN UNITY. IF THIS CONDITION IS INDEED REAL, THEN IN THE PAST MONTHS OF GENERALLY RECOGNIZED WORLD RECESSION, IT HOLDS THAT BRITAIN'S SHARE OF WORLD TRADE WOULD IN FACT INCREASE OR IN ANOTHER SENSE, THE LEVEL WOULD FALL LESS RAPIDLY THAN IN MANY OF THE OTHER INDUSTRIAL COUNTRIES; ONE POSSIBLE EXPLANATION OF THE RELATIVELY FLAT LEVEL OF EXPORT VOLUME.

B: THE ABOVE CITED GENERAL PERIOD OF RECESSION HAS IN FACT HIT BRITAIN MUCH LATER THAN MANY OF ITS MAJOR TRADING PARTNERS. THEREFORE, THE REDUCTION IN IMPORT DEMAND CAME MUCH LATER. WE WOULD OFFER IN FACT THAT THE REDUCTION IN CONSUMER DEMAND BEGAN ONLY RECENTLY; WITNESS THE DROP IN BOTH IMPORT VOLUME AND VALUE IN THE PAST FEW MONTHS. AS THE RECESSION DEEPENS, THE REDUCED LEVEL OF CONSUMER EXPENDITURE WILL BE REFLECTED IN THE LEVEL OF IMPORTS.

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C: THE VALUE OF STERLING, RELATIVE TO BRITAIN'S MAJOR TRADING PARTNERS, HAS BEEN MORE OR LESS CONSTANTLY DECLINING SINCE 1972. IT IS RECOGNIZED THAT THE J-CURVE EFFECT OF A DEVALUATION TAKES SEVERAL PERIODS TO WORK ITS WAY THROUGH. HOWEVER, THE EFFECTS OF A RATHER STEADY DEPRECIATION FOLLOWING A MAJOR DEVALUATION SHOULD, WE BELIEVE, NOT ONLY REDUCE THE SLOPE OF THE J-CURVE BUT ALSO TO REDUCE THE TIME LAGS OF THE TURNAROUND. WHILE WE RECOGNIZE THAT THIS IS A RATHER GENERALIZED STATEMENT THAT HAS NOT BEEN EMPIRICALLY TESTED, WE SUBMIT THAT THE BETTER THAN EXPECTED PERFORMANCE ON CURRENT ACCOUNT NOW BEING WITNESSED MAY IN PART BE ACCOUNTED FOR BY THE EFFECTS OF PAST AND CONTINUED DEVALUATION.

6. 1975 CURRENT ACCOUNT ESTIMATE. GIVEN THE LACK OF CERTAINTY OVER THE EFFECTS OF GOVERNMENTAL POLICIES EXPECTED TO BE INTRODUCED LATER THIS YEAR COMBINED WITH THE INABILITY TO ASCERTAIN CLEAR TRENDS IN BRITAIN'S EXTERNAL TRADE, WE ARE FORCED TO ESTIMATE THE CURRENT ACCOUNT BALANCE WITHIN WHAT WE CONSIDER TO BE A REASONABLE RANGE OF EXPECTATIONS. WHILE WE RECOGNIZE THAT THESE ESTIMATES ARE MORE OPTIMISTIC THAN ANY PUT FORTH TO DATE, WE FEEL THEY ARE PLAUSIBLE GIVEN PERFORMANCE DURING THE EARLY MONTHS OF 1975 AS WELL AS FOR THE REASONS CITED ABOVE REGARDING THE EFFECTS ON UK IMPORT AND EXPORT BEHAVIOR.

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A: CURRENT ESTIMATE  
(IN MILLIONS OF POUNDS)

	1975-I	1975-II
CURRENT ACCOUNT	-450 TO -625	-935 TO -1,175
TRADE BALANCE	-1,200 TO -1,375	-1,710 TO -1,950
INVISIBLE BALANCE	750	775

YEAR

CURRENT ACCOUNT	-1,385 TO -1,800
TRADE BALANCE	-2,910 TO -3,325
INVISIBLE BALANCE	1,525

B: IMPROVEMENT-1975 OVER 1974  
(IN MILLIONS OF POUNDS)

CURRENT ACCOUNT	2,385 - 1,970
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TRADE BALANCE 2,350 - 1,935  
INVISIBLE BALANCE 40  
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7. IN CONCLUSION WE MIGHT ADD THAT IT NOW APPEARS THAT THE UK WILL HAVE LITTLE DIFFICULTY IN FINANCING THE CURRENT ACCOUNT DEFICIT THIS YEAR, ESPECIALLY IF THE DEFICIT FALLS WITHIN THE RANGE OF ESTIMATES PRESENTED ABOVE (\$3.3 TO \$4.2 BILLION IF CONVERTED AT 1 POUND EQUALS \$2.35). AS OF THE END OF MAY, OFFICIAL H.M.G. BORROWING TOTALED \$1 BILLION (FINAL DRAWINGS ON \$2.5 BILLION EURODOLLAR LOAN) WITH AT LEAST ANOTHER \$400 MILLION TO BE DRAWN ON THE \$1.2 BILLION IRANIAN LOAN. IN ADDITION, THERE WERE ACCRUALS OF \$216 MILLION OF FOREIGN CURRENCY BORROWINGS BY THE PUBLIC SECTOR UNDER THE EXCHANGE COVER SCHEME. PROBLEMS COULD OCCUR, HOWEVER, IN FINANCING THE OUTFLOW OF CAPITAL IF A MAJOR SPECULATIVE RUN ON STERLING DEVELOPS LATER IN THE YEAR AND THE RATE IS DEFENDED.

NOTE 1: THE PRELIMINARY WORK ON THIS ESTIMATE WAS BEGUN PRIOR TO THE JUNE 13 RELEASE OF MAY TRADE DATA. ASSTFIN-ATT HELD A SERIES OF BACKGROUND DISCUSSIONS WITH OFFICIAL AND PRIVATE FORECASTERS AND WITH THE OECD SECRETARIAT DURING LATE MAY AND EARLY JUNE IN AN ATTEMPT TO ASCERTAIN IF FORECAST REVISIONS WERE BEING MADE. WHILE WE DO NOT EXPECT FORECASTERS TO, AS THE OECD SECRETARIAT PUT IT, "PRODUCE ESTIMATES WHICH FLIP-FLOP AROUND FROM MONTH TO MONTH," WE WERE SOMEWHAT SURPRISED AT WHAT WE FELT TO BE THE LACK OF RECOGNITION OF ACTUAL PERFORMANCE IN THE FIRST MONTHS OF THE YEAR. THIS LACK OF RECOGNITION WAS FIRST NOTICED IN EARLY MAY WHEN THE OECD REVISED DOWNWARD ITS ESTIMATES OF THE TOTAL OECD COUNTRIES' C/A DEFICIT, YET DID NOT REVISE THE UK ELEMENT IN THIS FORECAST, NOR WERE THERE ANY REVISIONS IN THE NIESR FORECAST RELEASED IN LATE MAY. THE GENERAL DIRECTION OF OUR ESTIMATES WERE FAIRLY WELL FORMULATED PRIOR TO THE RELEASE OF THE MAY DATA WHICH ADMITTEDLY WAS, IN THE UK SENSE, MORE FAVORABLE THAN ANTICIPATED. NONETHELESS, THE ACTUAL PERFORMANCE IN MAY REENFORCES THE OBSERVATIONS AND EXPECTATIONS CITED THROUGHOUT. ACCORDINGLY, THE ESTIMATES AND DATA WERE REVISED TO REFLECT THE TRADE PERFORMANCE DURING MAY.

NOTE FOR SSWRUD: PER TELEPHONE REQUEST FOR ADDITIONAL INFORMATION ON THE LARGE POSITIVE ERRORS AND OMISSIONS ITEM RECORDED IN THE 1974 AND FIRST QUARTER 1975 BALANCE  
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OF PAYMENTS FIGURES, WE HAVE CHECKED WITH HM TREASURY AND OTHER SOURCES. HOWEVER, SOURCES WERE UNABLE TO PROVIDE ANY ADDITIONAL EXPLANATIONS THAN THOSE CONTAINED IN PARAS 49 AND 26 OF THE RESPECTIVE HM TREASURY PRESS RELEASES, BOTH OF WHICH HAVE BEEN POUNCED TO YOU. (SEE ENCLOSURE TO LONDON A-243, MARCH 13, 1975, AND LONDON A-551 OF JUNE 18, 1975.) WE ARE CONTINUING TO CHECK INTO THIS MATTER AND WILL REPORT IF ADDED INFORMATION IS OBTAINED.

RICHARDSON

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